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MEMORANDUM

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TO: THE COMMISSION

FROM: Utilities Division

DATE: August 21, 2006

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AZ CORP COMMISSION
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RE: IN THE MATTER OF ARIZONA WATER COMPANY REQUEST FOR
ALTERATION OR AMENDMENT OF RATE FILING REQUIREMENTS,
DOCKET NO. W-01445A-02-0619

On June 20, 2006 Arizona Water Company ("Company") filed a request for alteration or amendment of rate filing requirements with the Arizona Corporation Commission ("Commission") regarding its Northern, Eastern and Western groups.

Attached is the Staff Report regarding the requests wherein the Staff recommends approval of the Company's request.

EGJ:JJD:mfm

Originator: James J. Dorf

Attachment: Original and sixteen copies

Arizona Corporation Commission

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Docket No. W-01445A-02-0619

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

ARIZONA WATER COMPANY

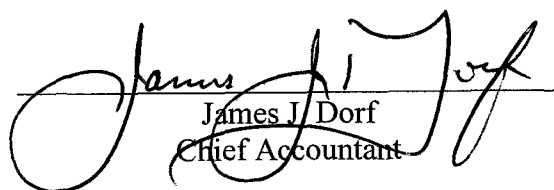
DOCKET NO. W-01445A-02-0619

**REQUEST FOR ALTERATION OR AMENDMENT
OF RATE FILING REQUIREMENTS**

AUGUST, 2006

STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Water Company ("Company"), Docket Nos. W-01445A-02-0619, was the responsibility of the Staff member James J. Dorf.



James J. Dorf
Chief Accountant

EXECUTIVE SUMMARY

Arizona Water Company ("Company") is a public service corporation which operates a total of 18 water systems located in eight Arizona counties serving over 70,000 customers. The applications involve the rate filing requirements established for each of the Company's systems; the Northern Group (Decision No. 66400), the Eastern Group (Decision No. 66849), and the Western Group (Decision No. 68302).

Pursuant to A.R.S. §40-252, the Company requests that the Arizona Corporation Commission ("Commission") alter or amend the rate case filing requirements established in each of the Decisions noted above. The basis for the request is a material change in the Arizona Department of Environmental Quality ("ADEQ") Arsenic Compliance Policy.

In 2001, the United States Environmental Protection Agency ("EPA") reduced the maximum contaminant level ("MCL") for arsenic in potable water from 50 parts per billion ("ppb") to 10 ppb effective January 23, 2006. In 2002, the Commission conducted a separate phase of the related general rate cases in which a procedure was developed to permit recovery of certain arsenic treatment costs. The Commission has approved recovery of such arsenic costs by adopting a streamlined filing procedure related to an arsenic cost recovery mechanism ("ACRM") for each of the Company's groups. The approvals were conditioned on the Company's filing a rate application no later than September 30, 2007, based on a 2006 test year.

Due to implementation delays based upon ADEQ revised compliance guidelines, the Company has experienced longer than anticipated time periods for obtaining approvals to construct its arsenic treatment facilities. The Company is requesting that the test year requirement be changed from 2006 to 2007.

Staff recommends approval of the Company's request to change the required filing date for the total Company rate case, upon which the ACRM was conditioned. However, since the Company will be filing three rate cases, those filings should be staggered. Therefore, staff recommends the first case be filed no later than June 30, 2008. The second no later than August 31, 2008 and the last no later than October 31, 2008. The Company may decide which case to file when.

Staff further recommends a change of the test year from 2006 to 2007 for the filing of a full general rate case as was required in the Decisions.

Staff further recommends that the Company be allowed arsenic treatment O&M costs recoverable under the ACRM to be deferred thorough 2007, instead of limiting them through 2006, as contemplated by the Decisions.

TABLE OF CONTENTS

PAGE

INTRODUCTION.....	1
ARSENIC COMPLIANCE DATES	1
ADEQ ARSENIC COMPLIANCE POLICY.....	1
ARIZONA WATER COMPANY TESTING SCHEDULE.....	1
STAFF ANALYSIS.....	2
STAFF RECOMMENDATIONS.....	2

Introduction

Arizona Water Company ("Company") is a public service corporation which operates a total of 18 water systems located in eight Arizona counties serving over 70,000 customers. The applications involve the rate filing requirements established in separate Arizona Corporation Commission ("Commission") rate Decisions for each of the Company's systems; the Northern Group (Decision No. 66400), the Eastern Group (Decision No. 66849), and the Western Group (Decision No. 68302) (collectively the "Decisions").

Pursuant to A.R.S. §40-252, the Company requests that the Arizona Corporation Commission ("Commission") alter or amend the rate case filing requirements established in each of the Decisions noted above. The basis for the request is a material change in the Arizona Department of Environmental Quality ("ADEQ") Arsenic Compliance Policy ("Policy").

Arsenic Compliance Dates

In 2001, the United States Environmental Protection Agency ("EPA") reduced the maximum contaminant level ("MCL") for arsenic in potable water from 50 parts per billion ("ppb") to 10 ppb effective January 23, 2006. In 2002, the Commission conducted a separate phase of the related general rate cases in which a procedure was developed to permit recovery of certain arsenic treatment costs. The Commission has approved recovery of such arsenic costs by adopting a streamlined filing procedure related to an arsenic cost recovery mechanism ("ACRM") for each of the Company's groups. The approvals were conditioned on the Company's filing a rate application no later than September 30, 2007, based on a 2006 test year which had anticipated arsenic compliance by January 23, 2006.

ADEQ Arsenic Compliance Policy

In October, 2005, the ADEQ issued its Arsenic Compliance Policy governing the first compliance period under the EPA's arsenic standard for the years 2005-2007. Under the Policy, water systems are required to monitor arsenic levels under their current monitoring frequency. Separate testing procedures apply to systems where arsenic exceeds 10 ppb, and for systems where the content is 10 ppb or less. For example, compliance monitoring must take place after January 23, 2006 for systems testing in excess of 10 ppb and compliance must be determined no later than December 31, 2007 (based upon the results of four quarterly samples).

Arizona Water Company Testing Schedule

Under the new ADEQ Policy, the compliance deadline for most of the Company's 18 systems is September 30, 2007, rather than January 23, 2006. Therefore, the Company indicates that its actual first full year of arsenic treatment costs will be 2007 instead of 2006 as contemplated in each of the Company's Decisions.

Due to implementation delays based upon ADEQ revised compliance guidelines, the Company has experienced longer than anticipated time periods for obtaining approvals to construct its arsenic treatment facilities. The Company has experienced delays in obtaining ADEQ approvals to construct and delays related to city/county planning and zoning approval, special use permits, conditional use permits and other construction related permits.

As of the date this application was filed, the arsenic treatment facilities were in various stages of construction but not yet complete. The Company anticipates it will take the remainder of 2006 and a part of 2007 for its contractors to complete the arsenic projects.

Therefore, the Company is unable to accurately determine the known and measurable cost of all of the arsenic related operating and maintenance expenses ("O&M") as of the end of 2006. The 2004-2006 time period contemplated for the ACRMs is no longer appropriate. Also, the Commission's requirement "for a full rate review which will be conducted after all of the Company's arsenic treatment costs are known and measurable"¹ will not be possible as of September 30, 2007. It is for these reasons that the Company is requesting that the test year requirement be changed from 2006 to 2007 and the rate filing date change to not later than September 30, 2008.

The Company also requests that it be allowed to continue to defer related O&M costs through 2007, instead of limiting them through 2006, as contemplated in the Decisions.

Staff Analysis

Staff concludes that the Company's requested relief is reasonable. The ADEQ Policy permits compliance with the new arsenic standard over a variety of time periods based upon each water systems initial monitoring year. As a result, the construction timing for completing arsenic treatment facilities has been changed.

The primary goal of implementing ACRM was to strike a reasonable balance between the Company's financing needs to comply with a federally mandated arsenic maximum contaminant level and avoidance of significant rate shock to customers who are affected by the arsenic requirements.

Staff Recommendations

Staff recommends approval of the Company's request to change the required filing date for the total Company rate case, upon which the ACRM was conditioned. However, since the Company will be filing three rate cases, those filings should be staggered. Therefore, Staff

¹ Decision No. 66400, page 9, lines 17-19.

recommends the first case be filed no later than June 30, 2008; the second no later than August 31, 2008; and the last no later than October 31, 2008. The Company may decide which case to file when.

Staff further recommends a change of the test year from 2006 to 2007 for the filing of a full general rate case as was required in the Decisions.

Staff further recommends that the Company be allowed arsenic treatment O&M costs recoverable under the ACRM to be deferred through 2007, instead of limiting them through 2006, as contemplated by the Decisions.